THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 394 **APRIL 2006**

In short, our prosperity was a false prosperity, built on borrowing from the future. The trouble with an economic policy that artificially boosts consumption at the expense of investment, dissipates assets and runs up debt is simply that each of these outcomes violates the essential trust that has always linked each generation to those that follow. We have enjoyed what appears to be a higher and more stable standard of living by selling our and our children's economic birthright.

— Benjamin Friedman, *Day of Reckoning*, 1988

THE SUPPLY-SIDE CONSEQUENCES OF MR. GREENSPAN

It has taken the Federal Reserve more than 20 months to raise its federal funds rate from 1% to its present 4.75%. The slowness of these rate hikes contrasts dramatically with the regular speed of rate cuts. One has to wonder about the true purpose of this extremely cautious policy. As a rule, central banks have hiked their rates in order to curb ongoing credit expansion. So far, the U.S. economy is experiencing the exact opposite.

In the fourth quarter of 2005, for which the Fed has just recently published the detailed figures, nonfinancial credit expanded at a new record rate of $2,445.7 billion. This compares with $1,710.5 billion in the second quarter of 2004, at the end of which the Fed started its rate hikes. Financial credit increased $1,224.4 billion, as against $932.7 billion in the second quarter of 2004.

In the aggregate, overall financial and nonfinancial credit growth accelerated over this period of rate hikes from $2,643.2 billion in the second quarter of 2004 to $3,670.1 billion in the fourth quarter of 2005. In rate of percentage, borrowing and lending increased a staggering 38.9%.

The fact to see is that all the rate hikes were undertaken in complete absence of any monetary tightening. Plainly, the Fed has readily provided any bank reserves that the financial system has needed to maintain its credit expansion. It is a farce of monetary tightening.

For all of 2005, total credit expanded $3.340 trillion, to $40.230 trillion, up more than $500 billion from 2004's record $2.818 trillion increase. For comparison, annual total credit growth averaged $1.237 trillion during the 1990s.

Trying to capture bubble dynamics, we compare the credit expansion with the simultaneous increase in real and nominal GDP. Well, in real terms, it was up $378.9 billion in 2005, and, in current dollars, $751.4 billion.

Credit growth vastly in excess of domestic expenditures and output, as measured by GDP, implicitly indicates a substantial shift in the pattern of credit-financed spending toward items that are not captured in the gross domestic product. One is asset purchases; the second is an import surplus reflecting purchases of foreign goods. The third item, escalating in importance, is Ponzi finance. That is, capitalization of unpaid interest.

Considering that outstanding U.S. indebtedness now exceeds $40 trillion, it is a compelling conclusion that the implicated debt service vastly exceeds what in the aggregate can be paid from current income. There has been huge borrowing in the hope of opulent profits from capital gains allowing the liquidation of both the debts and accumulated unpaid interest by selling later to a greater fool.

But who will be on the other side of the market when the highly leveraged asset holders want to sell? Nobody, definitely not at present price levels. More to the point, the vast liquidity needed to accommodate heavy asset selling

from an unwinding of the extensive carry trade does not exist.

There prevails a general comforting assumption that an existing liquidity deluge plus the "Greenspan put" excludes the possibility of a great liquidity risk. That is a gross error. All the "excess liquidity" sloshing around in global markets today depends upon borrowing against rising asset prices. An end to rising asset prices, not to speak of a crash, will mark the end of this excess liquidity.

A BIG SHIFT IN CARRY TRADE

America has an annual runaway credit expansion close to $3 trillion, as against zero available domestic savings. Given this horrendous imbalance, U.S. interest rates are absurdly low. One obvious well-known reason is the large bond purchases by Asian central banks. Yet given the raging U.S. credit expansion, there must be a lot more to it. These were large bond purchases by the banking system and even larger purchases through carry trade by nonbank institutions, among them hedge funds, of course.

But as the Fed flattened the yield curve through its rate hikes from the short end, carry trade funded in dollars has become unprofitable. That this completely failed to impact U.S. long-term rates was the great conundrum.

Carry-trade bubbles are regularly liquidated in a burst when something makes them unprofitable. In the autumn of 1998, such a trigger was the Asian crisis. After a long, steep fall since 1995, the yen abruptly shot up 20% due to the abrupt unwinding of yen carry trade.

It has to be realized that any decline in U.S. bond prices and any rise in the low-interest currencies puts the existing carry trades at risk. Their unwinding would confront the Fed with a tremendous policy dilemma of what to fight — the slumping dollar with rate hikes or the slumping bonds with looser money and rate cuts.

AN EVASIVE RECOVERY

In the early 2000s, Mr. Greenspan earned himself the honorable title of "serial bubble blower." Fearful of a painful burst of the equity bubble, he aided and abetted a bond bubble in order to boost the housing bubble. Measured by the mildest postwar recession, it appeared a smashing success. But taking measure of the following anemic recovery, and particularly the following dismal employment and income performance, into account, it was an utter policy failure.

Any assessment has to further take into account that the government and Federal Reserve have supported this recovery with unprecedented fiscal and monetary lavishness. Tax cuts reduced government revenue by $870 billion, while the Federal Reserve slashed its fed funds rate to 1%, its lowest level since the Great Depression.

The decisive failures of these policies have been in business fixed investment and in employment, both displaying a drastic shortfall in relation to reported GDP growth.

Economic Performance

Comparison With Past Cycles' Percent Growth From Peak Through 19 Quarters, or 58 Months

	Cycles		Percent Below
	Past	**Current**	**Past Cycles**
Business Investment	18.6%	6.5%	65%
Employment	7.1%	1%	86%
Gross Domestic Product	16.3%	13.8%	16%

Source: Economic Policy Institute, Washington

Historical experience and economic theory leave no doubt that business fixed investment and employment play the crucial role in providing economic growth with the necessary traction to become self-sustaining. Even in its fifth year,

the present U.S. economic recovery remains fully dependent on the housing bubble to drive the consumption bubble.

The same, by the way, applies more or less to all Anglo-Saxon countries. Over the past few years, all of them have hung on the steroid of inflating house prices providing the collateral for outsized consumer borrowing-and-spending binges. Their further common features are large budget deficits (except Australia), very low savings and large trade deficits (except Canada).

All of these economies have, in essence, become bubble economies. This means that monetary policy impacts the economy primarily through inflating asset prices, which in turn stimulate and facilitate credit-financed consumer spending.

An important adverse feature of all asset and credit bubbles is that they inherently break an economy's pattern of growth. In all the English-speaking countries, the credit excesses have primarily inflated house prices. Using these as rising collateral, consumers have enjoyed unprecedented borrowing facilities to spend as never before in excess of their current income. What resulted were extremely unbalanced economies.

Distorted demand over time invariably also distorts the economy's supply side. What has actually happened in all these countries is that domestic spending has increasingly outpaced domestic output. On the other hand, low domestic saving and capital investment keep a brake on output growth. The infallible result in all these countries, except Canada, is large, chronic trade deficits. Evidently, all this is structural, not cyclical.

Essentially, the low savings, the low capital investment and the soaring trade deficits act as major drags on economic growth. Over the past few years, these drags have been offset by the rampant demand creation through the housing bubbles. But the trouble with this recipe is that it worsens the structural distortions and imbalances.

Nevertheless, all asset and credit bubbles eventually run out of steam. Plainly, this is going on in all these bubble economies, the United States included. For us, the key question about whether there will be a hard or soft landing is the extent of the prior excesses. They are the worst in history.

The consensus sees new momentum in the U.S. economy from strong retail sales. We focus on the inflation-adjusted monthly figures for overall consumer outlays and observe the opposite. There are sharp fluctuations in spending on durables, but with a distinct downward trend.

U.S. Consumer Expenditures
Change From Preceding Month in Billions of Chained Dollars
(seasonally adjusted at annual rates)

	Jun 05	**Jul 05**	**Aug 05**	**Sep 05**	**Oct 05**	**Nov 05**	**Dec 05**	**Jan 06**
	80.4	85.4	–68.3	–49.3	6.1	72.8	57.4	29.6
Durables' Contribution	51.4	92.4	–106.1	–46.2	–28.5	41.4	45.3	14.6

Source: Personal Income and Outlays, *Bureau of Economic Analysis*

As everybody knows, or ought to know, the strong monthly changes in consumer spending have their main cause in the sharp ups and downs of auto promotions. In the quarterly GDP reports, they are even annualized. But comparing the above figures, it strikes the eye that the recovery in the last three months was very much weaker than in the prior downturn.

Any assessment of the U.S. economy's further course has to start with the recognition that the housing bubble is doomed, and in its wake the consumption bubble. Only the vigor of their slowdown is in question. Given this virtual certainty, the U.S. economy urgently needs an alternative source of growth.

Unfortunately, there is but one possible alternative source, and that is sharply rising business fixed investment and exports. The consensus, apparently, takes a strong revival of business fixed investment for granted.

Assessing the relevant figures, including profits, we take for granted that business investment and hiring are

going to fail in the future even more than in the past. *First of all*, the record-sized fiscal and monetary stimulus of all times has been exhausted; *second*, business fixed investment in the United States, even though heavily bloated by hedonic pricing of computers, recently accounts for a record low of 11.5% of GDP, as against more than 70% for consumer spending; *third*, consumer demand is weakening; and *fourth*, nonresidential investment has slumped from double-digit growth rates in 2004 to just 2.6% in the fourth quarter of 2005, after 10% in the first half.

Common arguments in favor of a comeback of capital investment are high business liquidity and high profits. Plainly, they have recovered from their lows, but growth has sharply slowed from 2004, when tax incentives gave a strong impetus.

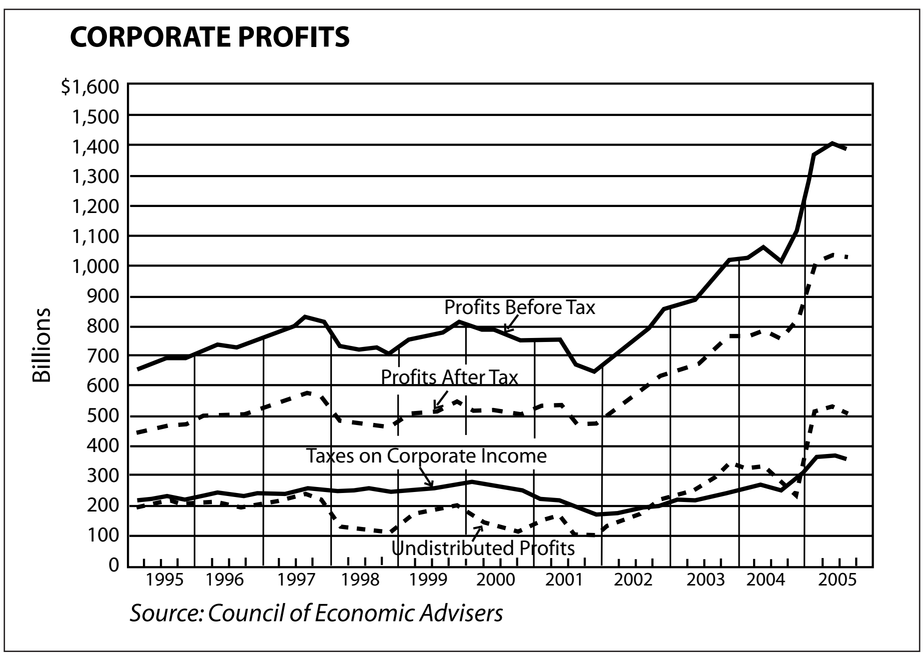
New orders for machinery are up over the year, but by far not enough to suggest a developing investment boom. Given for many years a preponderance of short-lived investments, it needs moreover large and ever-higher capital investments just to replace worn-out plant and equipment, as reflected in rising depreciations. There is every reason to assume that the rise in new orders of capital goods barely reflects rising depreciations.

PROFIT MAGICS

Most impressive is definitely the following chart reflecting the U.S. economy's profit performance. Since 2000, it is the greatest profit boom in the whole postwar period. Strikingly, it even compares most favorably with the profit performance during the "New Paradigm" boom years, from 1995–2000.

Profits of the whole nonfinancial sector were $401 billion in 1995 and $413.4 billion in 2000. But from 2001 to late 2005, they have almost trebled, from $322 billion to $868.5 billion. Wall Street, of course, eagerly seizes them. For us, these numbers are so absurd as to require investigation.

First of all, it was an extremely imbalanced profit boom reflecting an extremely imbalanced economic recovery. This recovery had literally nothing in common with the business cycle pattern of the past. Intrinsically, this shows in a radically divergent profit pattern.



As the following table on page 5 displays, the profit boom of the last few years was narrowly centered in the category "other." The fact is that the housing bubble has been crucial not only in creating demand and GDP growth, but also in creating employment and profits.

Most astonishing is, of course, the steep jump in profits from $534.2 billion in 2004 to $863.3 billion in 2005. Two phony causes are easily identified. One is a sharp decline in depreciations, from $804.3 billion to $668 billion. Depreciations are a business expense, of course. If a firm stops investment, it increases its profits. But this is hardly a desirable way toward higher profits. The second major cause of the sudden profit surge was a tax incentive that induced companies to repatriate a large amount of foreign profits into domestic profits.

Leaving aside the grossly distorted profit figures for 2005, we focus on the period from 1997–2004, the former marking the U.S. economy's prior profit peak in the postwar period. Over these seven years, including the "New Paradigm" boom years, overall profits barely rose.

U.S. Corporate Profits by Industry (in $ Billion)	1995	1997	2000	2004	2005*
Nonfinancial	401.0	508.4	413.4	534.2	863.3
Manufacturing	173.7	209.0	144.3	118.9	218.6
Durable goods	80.9	103.1	60.0	34.8	62.0
Nondurable goods	92.8	105.9	84.3	84.0	156.6
Transportation	85.8	84.2	14.9	8.4	32.9
Wholesale trade	27.3	47.6	59.7	63.5	95.4
Retail trade	43.1	64.2	59.6	90.0	116.9
Other	71.2	103.4	28.2	224.3	329.6
Rest of the world	92.8	110.9	145.7	184.9	223.1

* third quarter 2005 annualized

Source: National Income and Product Accounts, Bureau of Economic Analysis

The next thing to recognize is the tremendous differences in profit performance between sectors. For all sectors producing or moving goods, manufacturing and transportation, it has been seven years of profit disaster, and moreover of steady deterioration.

In contrast, it has been seven years of profit bonanza for retail trade, wholesale trade and in particular for the branches captured under “Other.” Here construction and real estate agents have been the main contributors.

We would say that overall this is a dismal profit performance, definitely giving no reason for a booming stock market. Measured against nominal GDP, which has risen 41% between 1997–2004, it is a profit collapse.

Very poor profits in the aggregate are the one big problem. An extremely lopsided pattern between sectors is the other. Manifestly, this lopsidedness in the profit pattern perfectly reflects the extraordinary lopsidedness of the U.S. economy’s growth pattern during these years. The housing and consumption bubbles rule.

It always amuses us when Mr. Greenspan and Mr. Bernanke criticize the government for its budget deficits. The irony is that the chronic deficit spending by the consumer, induced by their monetary looseness, is doing far greater structural damage to the economy.

DOWN TO ZERO CAPITAL FORMATION

Under Reaganomics in the 1980s, it caused great worries that the rising budget deficit was absorbing available savings. In response, Reagan raised taxes to reduce the deficit.

After averaging 4.1% of GDP during the first half of the decade, the federal budget deficit declined to 3.2% during the second half. As the stock market boom also lowered personal saving, the latter plunged from 6.8% in the late 1970s to an unprecedented low of 2.7% of GDP in the late 1980s.

Thanks to capital inflows, net capital investment held up significantly better than domestic savings, amounting to 5% of GDP in the late 1980s, against 7% early in the decade. Over the decade, the United States in addition moved from being an international net creditor of more than 13% of gross national product to a net debtor of around 7.5% in 1990.

At the same time, the monetary and fiscal policies applied during those years had started to alter the U.S. economy’s structure. As consumption took a growing share of GDP, both capital investment and foreign trade had to cede. No reasonable economist would regard this as a positive structural development.

Now to the capital formation in the Greenspan era. In the consensus view, the "New Paradigm" boom of the late 1990s stands out with a very high rate of capital investment. According to the official data, nonresidential investment between 1997–2000 accounted for 32% of real GDP growth. This almost matched Japan's record investment ratios. By these and other figures, it appeared that U.S. businesses during those "New Paradigm" years had grossly overinvested in new capacity, which implicitly led to the following "downward correction" in capital spending after 2000. Incidentally, this interpretation gives that slump a highly positive note as a desirable correction of prior overinvestment.

Let us take a look at the reality. The apparent "investment boom" of the late 1990s had two purely statistical reasons. The one consisted in prodigal "hedonic pricing" of computers, and the other consisted in the decision of the Bureau of Economic Analysis to treat business expenditures on software in the NIPA accounts no longer as business expense, but as business investment. By a stroke of the pen, the two statistical measures drastically boosted four aggregates: business profits, business investment, GDP and productivity growth

Businesses increased their actual spending on computers between 1997 – 2000 from $79.6 billion to $109.3 billion (in current dollars), or by $29.7 billion. But hedonic pricing multiplied this amount in the real GDP accounts sixfold to an increase of $187.4 billion, from $102.9 billion to $290.3 billion.

In combination, the increases from hedonic pricing of computers and the capitalization of outlays on software accounted for 21.3% of the reported real GDP growth and 77.2% of the trumpeted investment boom during those years. With these enormous boosts, the two statistical changes certainly played a key role in creating the "New Paradigm" hype.

Personal saving plummeted over the decade from 7% to a record low of 2.3% of disposable income in 1999. Intrinsically, a falling savings rate reflects a consumption boom, not an investment boom. For the purely numerical kind of investment boom that the BEA conjured up, it needs no savings, of course.

At the time, this letter was a lonely voice against those grossly distorting statistical practices. But in July 2002, we got an ally on Wall Street. Explicitly quoting the *"out-of-consensus view of economist Kurt Richebächer,"* Merrill Lynch published a report showing in detail the outrageous influence of hedonic pricing on the U.S. economy's reported performance. Verbatim: *"Although this quality of adjustment is reasonable, we find the boost to real spending seems out of line with reality"* (Merrill Lynch, *TechStrat Barometer*, July 12, 2002, by Steve Milunovich and Michael J. Ramirez).

Very soon, the Bureau of Economic Analysis reacted. They continued the practice, but suppressed its publication. Ever since, the line concerning investment in computers in chained dollars in the NIPA accounts is blank.

What truly happened during the "New Paradigm" years in the late 1990s was not an investment boom, but a consumption bubble stoked by the equity bubble. Its striking spectacular trademarks were the plummeting savings rate and the escalating U.S. trade deficit. As to capital formation, the statistical spin turned a new low into a new high.

We come to the economic development since 2000. Again, the general perception is one of a great policy success. The reality is an outright disaster on five counts: saving, capital investment, employment, labor income and foreign trade.

In 2005, personal savings fell into negative territory for the first time since the Great Depression in the 1930s. As to nonresidential capital spending, after a sharp slump over two years until early 2003, it has recovered. Still, it grossly lags overall growth. In 2005, it was just 6% above its level of 2000. Compared with simultaneous real GDP growth of 13.4%, it is badly lagging.

Again, it is necessary to warn about the preponderant role of hedonic pricing. Measured in current dollars, business investment in computers has risen just 4.2% since 2000. But in chained dollars, measuring computer power, the reported increase is a staggering 104.9%. For contrast, investment in industrial equipment is down 6.3% over this period.

To point to another shocking fact: Investment spending in the past few years has been grossly lagging current depreciations. As a result, net investment, adding to the capital stock, has slumped from $404.8 billion in 2000 to $223.7 billion. This works out as 1.8% of GDP, the U.S. economy's lowest rate of net nonresidential investment in the whole postwar period.

Still, there has been a roaring investment boom — in residential building. Its capital stock, measured by net investment, has sharply risen from $283.3 billion in 2000 to $442.8 billion in 2004. Essentially, this suggests considerable malinvestment.

Now, one last final calculation about capital formation in the United States. Combined, residential and nonresidential investment amounted to $666.5 billion in 2004. Against a simultaneous current account deficit of $668.1 billion, this implies that net domestic capital investment and the increase in foreign indebtedness have barely matched.

For 2005, the U.S. current account deficit was $805 billion, an increase of $137 billion, or 20% over 2000. To wit, it is escalating with growing speed, running now vastly and increasingly in excess of domestic capital formation. The thing to see is that the soaring capital inflows are financing a consumption excess, rather than capital investment.

WHERE DID THE PRODUCTIVITY GROWTH GO?

U.S. economic growth depends entirely on consumer borrowing using the house price bubble as collateral. This requires twofold credit excess — *first*, to inflate house prices; and *second*, to convert the rising house prices into higher consumer spending or other purchases.

Very loose money and credit is the first implicit condition. Yet this is not sufficient. In addition, it requires both willing lenders and borrowers readily regarding rising house prices as genuine wealth creation and valid collateral for borrowing. Manifestly, these lenders and borrowers are not lacking in the Anglo-Saxon countries.

But with a few exceptions, they are generally lacking in most European countries. House price inflation is taking place in splendid isolation. One obvious reason is that public opinion, in general, does not appreciate inflating house prices as "wealth creation." Characteristically, the subject of rising house prices rarely surfaces in the media. We tend to think of it as a gross difference in financial "culture" between Europe and the Anglo-Saxon countries.

Under the title "Globalization's New Underclass," Stephen Roach of Morgan Stanley developed a shocking contention that globalization has led to a global labor arbitrage exposing the work force in the industrialized countries to brutal wage compression, of which *"only the elite at the upper end of the occupational hierarchy"* has been spared.

This certainly describes the reality in the United States, where reported high rates of GDP and productivity growth coincide with falling real wages of the work force. In low-growth Europe and Japan, low general income growth is certainly not surprising.

Like many others, Mr. Roach is puzzled that the reported record productivity growth in the United States is concurring with record-low wage growth, expressing his assumption, probably a widespread one, that the "elite at the upper end" collects the big difference.

A similar view that *"recent productivity gains have not increased real income for the average American but have led to a concentration of wealth"* has been articulated in an article by Northwestern economics professors Ian Dew-Becker and Robert Gordon.

Asking who captured the benefits of the productivity growth explosion, Mr. Gordon states,

> *Median family income fell by 3.8 percent from 1999 to 2004 and grew cumulatively from 1995 – 2004 at an annual rate of 0.9 percent per year, much slower than the growth rate of nonfarm private business (NFPB) output per hour over the same period of 2.9 percent…*
>
> *The micro data tell a shocking story of gains accruing disproportionately to the top one percent and 0.1 percent of the income distribution.*

Some people are evidently amassing riches. But they definitely do not do it in the economy's production sphere. The fabulous profits are made in the financial sphere and the asset markets, where they have nothing to do with productivity, but everything to do with inflation and highly leveraged carry trade. All this is the privilege of financial institutions, firms and wealthy people.

LESS EXPENSES, LESS REVENUES

But who, then, is capturing the income gains from the reported stellar productivity growth? In short, nobody, because those big income gains that everybody attributes to productivity growth do not exist.

It is a general gross misapprehension that productivity growth implicitly raises incomes and profits. Just by itself, it is a mere measure of changes in labor costs per unit of output, no more, no less. Obviously, this adds to nobody's income. Nor does it automatically translate into higher business profits. What makes business profits is the difference between business expenses and business revenues.

Wages and salaries are a business expense. But consumer spending from those wages and salaries is a main source of business revenues. Obviously when wage earners trim their spending in line with their wage cuts, businesses gain nothing from wage cuts. The only effect is a slowing economy squeezing profits.

In its minutes, the Federal Reserve has repeatedly pointed to productivity growth as a source of the U.S. economy's strength. In reality, it is a mere statistical artifact creating by itself neither supply nor demand.

The singular drivers of domestic demand in the United States and other Anglo-Saxon countries are the housing bubbles and the consumer borrowing-and-spending binges they accommodate. Actually, credit-financed consumer spending, in contrast to wage-financed spending, boosts business profits. This major shift in the financing of consumer spending away from wages to debt has been most favorable for profits. The only mystery is that profits have fared so poorly.

We come to the wonders of U.S. GDP and productivity growth since 2000. Real GDP grew over the five years to 2005 by 13.4%, averaging 2.7% at annual rate. Productivity growth in the nonfarm sector even totaled 18.3%, averaging 3.6% per year. The consumer price index rose 14.7%, or 2.95% per annum. But median family income fell by 3.8% from 1999–2004.

For America's work force, this is the worst economic experience in the whole postwar period. In the 1970s, it was stagflation in wage rates, too, but with very strong employment growth.

WHERE THE ACTION IS

It is a striking fact in the U.S. macro statistics that the reported stellar growth rates for real GDP and productivity are grossly out of synch with the extremely poor employment and wage and salary figures.

This emphasis on productivity growth as the main source of a rising living standard has a tradition in the United States. The contrast to Europe is striking. In the works of the great European economists, productivity growth is rarely, if at all, cited. In vain, we looked for its mention in Schumpeter's voluminous *Business Cycles*.

American policymakers and economists have made a cult of reported productivity growth as the key measure of policy success in raising living standards. In contrast, European economists were aware that, just by itself, productivity growth is an economic nonentity.

There used to be general agreement, American economists included, that the growth of labor productivity has two prime ingredients: technological innovation and capital accumulation through saving. Either way, the action is in capital spending. Where there is sufficient capital spending, everything else — higher employment, higher profits, higher consumption and higher productivity — will take care of itself. It does, indeed.

Capital spending is, in fact, unique in the process of economic growth by playing two different roles. In its first

role, it increases demand, employment, incomes and tangible wealth while ordered plant and equipment are produced. Its second role starts with the installment of these capital goods for production. Now, the same capital spending adds to employment, incomes and productivity from the supply side through producing other goods.

Of course, the two processes impacting the economy from the demand and supply sides are in constant interplay. It may seem odd to American economists to associate high productivity growth with high employment growth creating high income growth. But what links all three is the capital-spending boom.

What about this interplay of capital spending in the United States over the past few years? Nonresidential capital spending has recovered from its sharp slump. That is the positive aspect. Yet at $1,289.7 billion in 2005, it barely exceeded its level of $1,232.1 billion in 2000. In other words, the present U.S. economic recovery suffers from a big deficit in capital spending. Taking rising depreciations into account, net capital investment has slumped.

According to official statistics, U.S. businesses have in the years since 2000 nevertheless enjoyed their highest productivity growth in history. Indeed, this is a miracle — if you believe it. We do not. This is flatly incompatible with the gross lack of capital spending.

DEMANDING HIGHER PRODUCTIVITY FIGURES

Chairman Greenspan used all his influence for a downward revision of the inflation rate. Given the eminent importance of that rate as the guide for monetary policy, it seems conclusive that he regarded lower rates helpful in keeping interest rates on the low side.

Remarkably, he also actively interfered in order to have better-looking productivity figures for the service sector, which were showing a small decline. This incident is described in detail in Bob Woodward's book about Greenspan, *Maestro*. After having questioned the poor productivity numbers for several years, Mr. Greenspan took action in 1996 in the face of mounting pressure from Federal Open Market Committee members to raise rates. They worried that the NAIRU, the non-accelerating inflation rate of unemployment, had dipped below the critical level of 6%.

Greenspan saw a low inflation rate and no real increases in labor costs, but simultaneous steep profit increases. For him, the only possible explanation of this coincidence was higher productivity growth than recorded. From this perspective, a rate hike appeared unjustified. Each staff forecast before the FOMC meetings had insisted that inflation was about to take off.

One paragraph in Woodward's book in this connection, quoting an FOMC member, particularly fascinated us: *"Outsiders and noneconomists thought his Fedspeak was the language of economics, but the chairman's language was highly idiosyncratic, often not fully grounded in the data. He was prone to take leaps. At the FOMC, the Ph.D.s on the committee, or some members of the staff, would be nearly rolling their eyes as the chairman voiced his views about how the economy might be changing. Nobody challenged him or dared say anything, but it weakened his hold on the committee."*

Adamant in his strong desire for better-looking productivity numbers, Mr. Greenspan summoned the Fed's chief economists and later also the chief economists of the Bureau of Labor Statistics, presenting his arguments and urging them to undertake closer studies to find the hidden productivity growth.

For some reason or other, the year 1996 became the start of the U.S. economy's protracted productivity miracle, which was to play a key role in generating the "New Paradigm" euphoria.

We think, though, that hedonic pricing and various other methodological changes significantly lowering the inflation rate were the decisive contributors to the sharply higher productivity growth.

FOR THE PUBLIC, IT IS STAGFLATION

Definitely, the U.S. productivity miracle of recent years was not the product of capital spending. America is, historically, a low savings and investment country. But with both of them down to record lows lately, the economy's

whole structure must adjust to unprecedented capital shortage.

As consumer spending takes a rising share of GDP, it pulls resources away from capital investment and foreign trade. The first shows in declining growth of the capital stock, particularly in manufacturing, and the second in the soaring trade deficit. Friedrich Hayek has investigated in detail the impact of this process of shrinking capital formation on economic growth, describing it as *"shrinkage in the structure of production"* or as *"shortening of the roundabout, capitalistic process of production."* His conclusion: It leads to depression.

As the "engine of growth," capital spending, particularly in long-lived assets, has two tremendous advantages over consumer spending. *First*, it has much higher multiplier effects on spending and incomes across the whole economy through creating employment in the capital goods industries; and *second*, capital spending through depreciations and retained earnings is self-financing. Debts are temporary.

In essence, the U.S. economy's production structure is becoming less capitalistic. Highly capital-intensive manufacturing has lost 3 million jobs since 2000. All job gains have been in residential building and services, a large part of which is also related to the housing bubble, prominently among real estate agents and financial services. But all these sectors are notorious for very little productivity growth.

For the broad working public, it has been stagflation in the past few years, and we would say that nothing else is to be expected in an economy in which saving and investment is being abolished. It is the difference between a household that lives from hand to mouth and one that saves and invests.

STATISTICAL AND ECONOMIC MYSTERIES

The great mystery is how this kind of structural change due to declining capital formation is able to bring about a productivity miracle. Of course, 3 million job losses in manufacturing give a tremendous boost to measured productivity growth. But as pointed out earlier, firing people is not enough to have higher productivity growth with higher income growth. To make it effective in terms of income growth, higher spending is also needed.

What demands explanation is the strikingly superior performance of real GDP and productivity growth compared with virtual stagflation for the broad public. In our view, the decisive economic reality is the latter. Besides, this stagflation perfectly conforms to the described changes in the U.S. economy's output structure toward sharply lower capital formation.

But how do they create the productivity miracle? Nothing is easier. Hedonic pricing is the most obvious and also most important device. To recap, it converts quality improvements into price reductions, which in turn correspondingly increase inflation-adjusted real GDP, and, in further consequence, also productivity growth.

The thing to see is that lowering the inflation rates by merely 2 percentage points makes all the difference for a productivity miracle. The advocates of hedonic pricing have actually emphasized this positive effect on real GDP and productivity growth as one of the advantages.

During the 1990s, it suddenly became the mantra of government economists, including Mr. Greenspan, that reported U.S. inflation rates are grossly overstated because improvements in quality are not taken into account. For the former, a substantial downward revision of the inflation rate had the main purpose to save the government a lot of money on inflation-tied social expenditures; Mr. Greenspan, on the other hand, certainly considered a lower inflation helpful in keeping interest rates rather low.

In the later 1990s, President Clinton convoked a special Advisory Commission to Study the Consumer Price Index. It started its work with the explicit inference that inflation rates were significantly overstated. The commission's final report, issued in 1996, declared that mainly for this reason the annual rate of inflation was overstated by about 1.1 percentage points. This, and probably more, has since been shaved off the inflation rate, adding correspondingly to real GDP growth.

Both the Bureau of Labor Statistics and the Bureau of Economic Analysis guard the effect of hedonic pricing on the inflation rates as a secret. It would be important to know. One has to assume that they do not want the public to know, for the probable reason that its contribution is pretty important.

It is widely estimated that hedonic pricing reduces the consumer price index by 1.5 percentage points and the GDP deflator in total by at least 2 percentage points. It should be clear that this has played a crucial role in generating the good-looking growth numbers for the U.S. economy's performance during recent years.

It is our long-held strong view that this extensive statistical treatment of quality improvements in America is not reasonable. Such improvements have always been an integral part of economic and technical progress. If producers decide to deliver them without a price increase, why should the government statisticians treat this as an increase in real income for buyers?

Genuine price reductions for the buyer mean that he saves money, which he can use for other purposes. Literally, it increases his disposable real income. But in the case of hedonic pricing, the income gain takes place only in the statistics, not in bank accounts.

In the case of computers, as pointed out, hedonic pricing during 2000–05 has translated an increase in current dollars by 4.2%, to a stunning increase by 104% in real terms. In this way, the mere purchase of a computer boosts real GDP and productivity growth even before it has been put to use. What about further contributions from their use?

We have pursued these and other changes in the U.S. statistics for years with great misgivings. There has been an unusual, concerted drive to produce better-looking statistics. Obviously, these contributions have been decisive in creating the perception of the U.S. economy's superior performance. The particular importance of the inflation rate arises from the fact that it has a large effect on real GDP and productivity growth, two aggregates of highest economic and political assessment.

WHAT NEXT?

According to the consensus forecasts, the U.S. economy is in robust shape and will continue to forge ahead at recent growth rates of around 3.5% for as far as the eye can see. Looking at the various big imbalances, we see an economy in very bad structural shape. There are really two key questions: *first*, soft or hard landing of the housing bubble? And *second*, is business fixed investment taking over from consumer spending as the economy's driver?

Trying to make our own judgment, we scrutinize the recent data flow. Putting particular weight on the housing bubble, we observe distinctly more weakness than strength, and we think that this weakness is sure to accelerate. Mr. Bernanke seized the occasion of his first address to stress again his familiar view that under present conditions the flat yield curve is quite harmless because interest rates are still at historic lows.

As it happens, we disagree with both sides. What matters more than interest rates is monetary tightness. We are sure that the emergence of an inverted yield curve in the past reflected truly tight money. This time, the Fed has maintained full monetary looseness, as measured by the growth of high-powered money and credit. The changes in the U.S. yield curve are the mere product of rate hikes at the short end.

Yet it had an important effect, not on the U.S. economy, but on the U.S. currency. The rate hikes at the short end curbed dollar-funded carry trade. But instead of closing their positions, many carry traders shifted their funding to the currencies with low interest rates — yen, euro and Swiss franc. The new result: a strong dollar on top of very low U.S. long-term interest rates.

The great question now is what may most probably upset the U.S. bubble system, now heavily exposed to carry trade in foreign currencies. We think the main threat is obvious, and actually in the making. That is a weakening U.S. economy forcing the Fed to stop its rate hikes, and later to cut them. Relatively strong U.S. economic growth and the rising interest rate differential at the short end have been a main pillar of the dollar's strength.

A weakening U.S. economy is bound to crack this pillar. Due to the gigantic leverage implicit to carry trade, a

modest rise of the yen, euro and Swiss franc against the dollar by just 2–3 percentage points is enough to abruptly torpedo the whole carry trade in these currencies, triggering a fire sale of unimaginable proportions of both dollars and U.S. bonds. In our view, this is plainly written on the wall, and a true miracle is needed to avoid this debacle.

This has just happened to the Icelandic krona, the New Zealand dollar and several other minor currencies crashing by double-digit rates. The point is that owing to the heavy leverage involved, conditions for a violent chaotic unwinding are prone to abruptly evolve. Any selling may quickly turn into an unstoppable avalanche when participants suddenly recognize a risk. Since early last year, shorting the yen, the euro and the Swiss franc has been deemed to be a safe, one-way bet. This can suddenly change.

There is no way to know the depth and pervasiveness of the U.S. carry trade funded in foreign currencies. In our view, it must be immense, simply because there exist no domestic savings to fund the rampant credit expansion. The whole U.S. financial system is built on carry trade, borrowing short and lending long.

As to the general hopes that a weakening economy will lower long-term rates and boost bond prices, we have to warn that the rapid unwinding of the carry trade in response to dollar weakness will probably overwhelm this effect and send U.S. bond prices sharply downward.

CONCLUSIONS:

For many years, the Federal Reserve has regularly surprised with a bias towards monetary looseness. Apparently, it has decided for the first time to surprise in the opposite direction, even though the housing bubble is glaringly tapering off. However, the tough talk contrasts oddly with still accelerating credit growth.

A main argument suggesting strong hiring and investment spending by businesses is highly liquid corporate balance sheets. But this unusual abundance of liquidity has one main reason in the protracted weakness of investment, and another in the temporary tax-induced gusher of repatriated earnings coming from overseas operations.

Taking these two factors for 2005 and the extremely lopsided profit pattern between sectors into account, the profit performance is in reality most disappointing, both objectively, but, above all, in comparison to the prevailing hype.

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